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STATE PASS TO FED BOARD OF GOVERNORS FOR ROBITAILLE

E.O. 12958: N/A
TAGS: ECON PGOV EFIN SOCI BR
SUBJECT: BRAZIL'S FISCAL RESPONSIBILITY LAW FACES FIRST
REAL TEST

REF: A) RIO DE JANEIRO 076,

B) 04 RIO DE JANEIRO 1261,
C) 04 RIO DE JANIERO 1773
D) BRASILIA 317

¶1. (U) This cable has been coordinated with Consulates Sao Paulo and Rio de Janeiro.

¶2. (SBU) SUMMARY. Brazil's Fiscal Responsibility Law (LRF), a cornerstone of the nation's fiscal recovery, is facing its most serious threat since its enactment in 2000. The law, meant to enforce prudent government financial management, requires that outgoing elected officials not leave unpaid obligations for an incoming administration, and it subjects officials who fail to respect its requirements to criminal penalties. Despite these provisions, reportedly over 2,000 of Brazil's 5,563 municipalities had uncovered obligations on January 1, when the new mayors were sworn in. The situation is testing the enforceability of the LRF across the country. Most tellingly, the accounts left by outgoing Sao Paulo mayor Marta Suplicy, a leader in President Lula's own PT party, whose default on at least R$1.8 billion (about $660 million) worth of contracts with suppliers confronts Lula with a series of uncomfortable choices regarding enforcement of the LRF. We see little chance, however, that the GoB will risk its hard-won fiscal gains with hasty reactions to the current outcry. End Summary.

The LRF - Cornerstone of Brazil's Fiscal Recovery

¶3. (U) The LRF was born of a general debt crisis in the late 1990s when several highly indebted state and municipal governments threatened again to default on their debts, forcing the GOB to step in to avert a general financial meltdown. In return for assuming state and municipal bank debt, the GoB forced local authorities to acquiesce to several measures meant to place a "fiscal straightjacket" on state and municipal governments. Originally passed in 2000, the law ties together a series of measures, often referred to collectively, although each has a separate legal basis. The first of these are the debt renegotiation contracts, signed between the federal government and the states and municipalities. While the states and municipalities must repay the federal government for the debt it assumed on their behalf, payments are capped at 13% of revenues.

¶4. (U) The second measure is the Senate's constitutional authority to set ceilings on state and municipality debt. These limitations prevent highly indebted states and cities from taking on new bank loans. The third leg of the stool is the LRF itself, which regulates financial administration and transparency. In particular, the LRF requires that outgoing governors and mayors balance the accounts at the end of their terms, and not leave uncovered financial obligations for their successors. A complementary statute, the law on fiscal crimes, establishes criminal penalties, ranging from prohibition on running for public office to four years imprisonment, for failing to respect the LRF's requirements.

The Challenge: New Municipal Leaders Find Empty Coffers

¶5. (U) The January 1, 2005 swearing in of mayors and city councils elected in October 2004 was the first municipal-level transition after the LRF took effect in 2000, and consequently the first municipal-level test of the LRF. (NOTE: LRF provisions were tested at the state level after the Brazil's gubernatorial elections two years ago. Reftels discuss several examples of states in bad financial shape in 2002 that have gotten their financial acts together. END NOTE.) Despite the provisions of the LRF, over 2,000 of Brazil's 5,563 municipalities reportedly had uncovered obligations on January 1 when the new mayors were sworn in -

- and no money in the bank with which to pay. Given the size of Sao Paulo's uncovered obligations alone (US $660 million), the total may be over a billion dollars.

¶6. (U) Fortaleza, capital of the northeastern state of Ceara, for example, is facing significant unpaid obligations. Newly arrived mayor Luizianne Lins (PT) reportedly found that her predecessor stopped paying city employees after the October elections, leaving the payroll 13 million US dollars in arrears. Lins, a maverick -- and outspokenly critical -- member of President Lula's Workers' Party (PT), came to Brasilia to plead, unsuccessfully, for federal assistance. In Aguas Lindas in Goais state, the incoming officials have had to buy cleaning products for the office out of their own pockets. Mixed in with the examples of financial mismanagement are horror stories of mayors who embezzled city funds in their final weeks in office, and in some cases even stole the computers that would help the new mayors (and prosecutors) assess the damage.

Sao Paulo at the Center of the Storm (as usual)
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¶7. (SBU) The largest municipal fiscal shortfall -- and politically most difficult case -- is Sao Paulo. Raul Velloso (please protect), an economist and financial consultant with ties to newly-inaugurated mayor Jose Serra and the Social Democratic Party (PSDB), told us that when Mayor Marta Suplicy (a PT leader close to President Lula) left office in December, she left behind substantial unpaid obligations to suppliers, which he estimated at R$1.8 billion. While Velloso acknowledged that Suplicy inherited R$1 billion of supplier debt from her predecessor, she took office before the LRF was enacted, he observed, and thus was on notice that she had to increase fiscal discipline. Instead, Velloso commented, Suplicy managed the city poorly and added to Sao Paulo's overall supplier debts, making it impossible for her to hand over the municipality with clean books.

¶8. (SBU) This failure would have been a clear violation of the LRF. To avoid liability under the law, Velloso said, Suplicy defaulted on the R$1.8 billion in supplier credits by voiding the municipal payment obligations, thus taking advantage of what appears to be a loophole in the law. While the LRF clearly prohibits an elected official from leaving office with uncovered obligations, it does not specifically enjoin a municipality from defaulting on those obligations during a transition. Outgoing Suplicy administration officials maintain that payments were suspended in late December only on services not yet provided, or which had not been accepted due to technical problems. But, the contractors and the Serra administration claim that Suplicy failed to pay for services rendered and that there were insufficient funds left on hand to cover upcoming payment obligations.

¶9. (SBU) While the defaults are subject to legal challenge, Velloso pointed out that enforcement of judicial decisions requiring municipal payments is spotty at best. Even if recognized by a judge, claims based on court judgments do not count as supplier debt under the LRF definition. Thus, Suplicy appears to have been able to leave office without violating the letter of the law while nevertheless bequeathing a financial mess of massive proportions to her successor.

¶10. (U) On January 31, losing mayoral candidate Paulo Pereira da Silva of the opposition PDT delivered a petition to the Sao Paulo state public prosecutor, Rodrigo Cesar Rebello Pinho, requesting that Suplicy be prosecuted for violation of the LRF. According to press reports, da Silva stated, "If the law doesn't stick here, in Sao Paulo, it's not going to stick anywhere." The PDT alleges a R$1.9 billion deficit in the accounts. Suplicy administration officials deny any LRF violation, claim that the end-of-year accounts contained R$ 376 million cash to cover outstanding obligations and dismiss the R$ 1.9 billion deficit estimate as including obligations which are not covered by the LRF, such as expenditures by municipal parastatals and city council expenses. In a related action, PSDB city councilman Jose Police Neto will also file an action with the state public prosecutor charging the former mayor with financial irregularities due to the cancellation of payments on service contracts in late December. The state prosecutor reportedly is reviewing both petitions.

...While debt to the Feds Grows on Parallel Track
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¶11. (SBU) Serra's penniless incoming municipal administration had to face an immediate threat on a parallel track: the city's debt to the federal government. According to several accounts, Serra and Suplicy met immediately before Serra's inauguration with federal Finance Minister Palocci to brief him on the situation and request that the

city's December debt payment to the federal government be postponed until mid-January. Normally, missing a payment would result in the GoB freezing the city's assets or canceling federal transfer payments. By all accounts, however, the Lula administration approved the "special consideration" and allowed the city to defer the December payment in order to cover other obligations. Quizzed about the apparent preferential treatment being given to Sao Paulo, a Finance Ministry contact claimed to Emboff that there was legal basis for the decision (though not specifying what it was) and that the media was making too much of the situation.

¶12. (U) Another strand in this affair are the limits on municipal and state debts set by the Senate, which apply to bank debt as well as to the renegotiated debt to the federal government. Velloso explained that Sao Paulo's situation had highlighted a technical problem with the manner in which overall debt stocks were indexed for inflation in the debt renegotiation contracts signed with the federal government in the late 1990s. The negotiators chose to index the debt stocks using the IGP-DI index, a mixed consumer and wholesale inflation index. The IGP-DI is much more sensitive to exchange rate swings -- of the sort Brazil experienced in 2002/2003 -- than Brazil's consumer price index (IPCA). Municipal revenue growth, however, tends to be closely correlated with the IPCA. This mismatch means that the growth in revenues has not kept pace with the growth in the debt stock over the last two years. End result: Sao Paulo's debt will be about R$7 billion over the 120% of revenues limit when the grace period for meeting the target expires in April. Given the city's 2005 budget of R$15.2 billion, it would be impossible for Serra to reduce the city's debt by the R$7 billion necessary to meet the target. Failure to meet the target would, in theory, restrict Sao Paulo from taking on new debt and allow the GoB to freeze transfer payments to the city.

Comment - Uncomfortable Situation

¶13. (SBU) The Lula administration is in a quandary. The large unpaid obligations left by many outgoing mayors, coupled in many cases with blatant mismanagement or even outright embezzlement, has given rise to calls for strict enforcement of LRF penalties. The presence of Sao Paulo at the center of this story, however, may limit the administration's options since, exploitation of loopholes aside, strict LRF enforcement would require that the GoB at least investigate Marta Suplicy's financial management. In addition to causing intra-party heartburn, doing so would mean dragging the details of her (alleged) financial mismanagement through the media, undermining the PT's efforts to burnish its image as a fiscally responsible manager at the federal level. Moreover, the sheer size of the Sao Paulo municipal budget, the fourth largest public budget in Brazil, might give the Lula administration pause, because proof of serious financial mismanagement and default could have a ripple effect throughout the financial system. The issue may get out of the administration's hands, however, should prosecutors take up opposition requests for an investigation.

¶14. (SBU) On a parallel track, the broad-based nature of the municipal financial difficulties has led to the most serious public questioning of the LRF's requirements to date. Several measures are being floated in Congress to soften the debt ceilings or endorse special treatment for some municipalities, although none of these is likely to pass without the support of the PT. However, the Lula administration cannot associate itself with calls to revisit the LRF's requirements (even where there would seem to be a legitimate case for doing so, such as the indexation mismatch problem). Doing so, in the words of the IMF Resident Representative, would be perceived by the international financial markets as "playing with fire." The GoB also must tread cautiously with Serra, who is in a position to embarrass the PT with revelations of Suplicy mismanagement. Serra has been surprisingly circumspect to date, perhaps hoping to make a deal with the federal government. But giving Sao Paulo (further) special treatment might undermine the LRF's credibility.

¶15. (SBU) The good news is twofold. First, despite these political conundrums, we have seen no evidence -- including during the Ambassador's February 1 meeting with Palocci (Ref D) -- that the GoB is prepared to risk Brazil's hard-won fiscal adjustment with hasty reactions. Second, when the GOB remained firm two years ago with newly elected governors -- who also clamored for exceptions and special treatment to overcome their inherited financial problems -- the states ultimately buckled down and began putting their financial houses in order.

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